Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:STP:TL-N-998-01
JForsberg

date: March 28, 2001

to: Mike Beckman, Group Manager, Group 1625

from: Associate Area Counsel (LMSB)
St. Paul, Minnesota

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ubject: [redacted]
Small S Corporation Status

Our advice has been requested as to whether [redacted] should be treated as a small S corporation excluded from the unified S corporation procedures of former subchapter D of chapter 63 of subtitle F. For the reasons discussed below, we believe that [redacted] was not a small S corporation as defined by Temp. Reg. 301.6241-1T(c)(2) and is therefore subject to the unified S corporation procedures.

FACTS

[redacted] is a California corporation which was incorporated on [redacted], under the name of [redacted]. The name of the corporation was changed to [redacted] by an amendment to its articles of incorporation filed on [redacted]. [redacted] has a taxable year ending [redacted]. [redacted] was in the business of operating a [redacted] in Los Angeles.

Based on information recently provided by the taxpayer, it appears that [redacted] has at all time been wholly-owned by The [redacted] (the "Trust"). The Trust is a grantor trust established by [redacted], a.k.a. [redacted], a.k.a. [redacted] (hereafter "[redacted]").

It was apparently intended that [redacted] be an S corporation at all times from incorporation. However, no Form 2553 electing S status was filed for [redacted] until [redacted]. On or about [redacted], [redacted] submitted a request for a private letter ruling granting it retroactive S corporation status pursuant to I.R.C. §1362(b)(5). On [redacted],

[redacted] was issued a private letter ruling which recognized it as an S corporation effective as of its date of incorporation.

[redacted] did not file a return for the TYE [redacted]. The operations of [redacted] nightclub for [redacted] were recorded on the general ledger of [redacted], a related taxpayer, and were apparently reported on [redacted]'s return.

On or about [redacted], [redacted] filed a Form 1120-S for [redacted] reflecting a loss for the year. The K-1 attached to the [redacted] Form 1120-S showed [redacted], not the Trust, as [redacted]'s [redacted] percent shareholder. On Schedule E of [redacted]'s [redacted] Form 1040 the [redacted] loss was reported as a direct flow-through from [redacted]. The [redacted] Form 1120-S only reported the income and expenses for the last half of [redacted]. Income and expenses for the [redacted] of [redacted] were not reflected on [redacted]'s ledger or return or those of [redacted].

On or about [redacted], [redacted] filed a Form 1120-S for [redacted] reflecting a loss for the year. The K-1 attached to the [redacted] Form 1120-S again showed [redacted] as [redacted]'s [redacted] percent shareholder. On Schedule E of [redacted]'s [redacted] Form 1040 the [redacted] loss was reported as a direct flow-through from [redacted].

Per transcripts of account, [redacted] filed Forms 1120-S for [redacted] and [redacted] which reported no income, expenses, or assets. It is not known what was reflected on the Forms K-1 for those years. The Schedules E attached to [redacted]'s [redacted] and [redacted] Forms 1040 reflected a direct flow-through from [redacted] of "none."

The examination of [redacted]'s taxable year [redacted] was opened in [redacted]. At that time the agents assigned the case were not aware that the Trust, not [redacted], was [redacted]'s sole shareholder. The agents first suspected that [redacted] was not the shareholder on [redacted], when they received corporate minutes which made reference to the Trust as corporation's shareholder. A written request for [redacted]'s stock certificates and shareholder history was made on [redacted]. On [redacted], the taxpayer responded that it did not have copies of the stock certificates. At that time the taxpayer did not provide a written shareholder history. The taxpayer's responses to further inquiries did not clarify who owned [redacted]'s stock.

The taxpayer first explicitly acknowledged that the Trust was its sole shareholder in the private letter ruling request dated [redacted]. On [redacted], the taxpayer provided the agents with an unsigned [redacted] stock certificate

issued to the Trust dated [redacted], along with a copy of the Trust document. (To date, no evidence of any capital contributions by either [redacted] or the Trust has been provided or discovered.) On [redacted], the taxpayer submitted a Form 56 (Notice Concerning Fiduciary Relationship) to the agents identifying [redacted] as fiduciary for [redacted].

In [redacted], [redacted] filed claims for [redacted] for unclaimed losses incurred in connection with the operation of the [redacted] nightclub. The agents have determined that the putative losses were incurred, if at all, by [redacted], not [redacted]. The statute of limitations for filing a claim for [redacted]'s taxable year [redacted] has expired. The statute of limitations on [redacted]'s taxable years [redacted], [redacted], and [redacted] have all been extended to [redacted].

DISCUSSION

As in effect for taxable years ending prior to [redacted], former subchapter D of chapter 63 of subtitle F provided generally that S corporation were subject to unified audit and litigation procedures similar to the TEFRA partnerships provision of subchapter C of chapter 63. Section 6241, however, granted the Secretary authority to promulgate regulations to except certain S corporations from the unified S corporation procedures. Pursuant to that authority, Temp. Reg. 301.6241-1T(c)(2) excepted "small S corporations" from the unified procedures. Subparagraph (c)(2)(ii) of the regulation defined a small S corporation as "an S corporation with 5 or fewer shareholders, each of whom is a natural person or an estate." Subparagraph (c)(2)(iii) provided:

> The exception provided in paragraph (c)(2)(ii) of this section does not apply to an S corporation for a taxable year if any shareholder in the corporation during that taxable years is a pass-through shareholder. For purposes of this paragraph (c)(2)(iii), a pass-through shareholder is -
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> (A) A trust;
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> (B) A nominee; or
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> (C) Other similar pass-through persons through whom other persons have an ownership interest in the stock of the S corporation. For purposes of the preceding sentence, a shareholder's estate shall not be treated as a pass-through shareholder.

Subparagraph (c)(2)(i) provided that the small S corporation exception was applicable for taxable years the due date of the return for which was on or after [redacted].

In the present case, [redacted] did not come within definition of a small S corporation for its taxable years [redacted], and [redacted]. While [redacted] met the five or fewer shareholders requirement, its sole shareholder, the Trust, was a "pass-through shareholder," not a "natural person or an estate," and, accordingly, [redacted] was not a small S corporation. The fact that the Trust was a grantor trust does not change the result. While a grantor trust is not taxed as a separate entity for Federal income purposes, it is separate entity for state law purposes and clearly comes within the definition of a pass-through shareholder. Primco Management Company v. Commissioner, T.C. Memo. 1997-332.

Your memorandum raises the issue of whether [redacted] should be treated as a small S corporation under the rationale of Harrell v. Commissioner, 91 T. C. 242 (1988) and Z-Tron Computer Research & Development Program v. Commissioner, 91 T.C. 258 (1988).[1] Harrell and Z-Tron involved the issue of whether the partnerships in question met the "same share" requirement of the small partnership exception of section 6231(a)(1)(B)(i)(II). That section defines a small partnership as one were, inter alia, "each partner's share of each partnership item is the same as his share of every other item." In Harrell and Z-Tron, the Tax Court held that the determination of whether the same share requirement test is satisfied was to be made "as of the date of the commencement of the audit of the partnership (but not necessarily on that date) by examining the partnership return and the corresponding Schedules K-1, and any amendments thereto received prior to this date." Harrell, 91 T.C. at 246. While the Court acknowledged that the references to a "partner's share" in the statute was a references to the partner's distributive share as determined under the partnership agreement, the Court was plainly

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[1] Your memorandum also notes I.R.C. §6231(g). Section 6231(g)(2) extends the small partnership exception to any partnership with respect to which the Service has, based on the partnership return, reasonably but erroneously determined that the small partnership exception does not apply. Section 6231(g), however, applies only to taxable years ending after August 5, 1997. Further, as discussed below, we do not believe that the provisions of the small partnership exception were incorporated into the small S corporation exception.

concerned with the administrative difficulties which would arise from having the application of the TEFRA procedures turn on the interpretation of a partnership agreement. It was this administrative consideration which seems to have persuaded the Court to adopt a "within the four-corners of the return" approach.

In the present case, the K-1s attached to [redacted]'s [redacted] and [redacted] Forms 1120-S showed [redacted], not the Trust, as [redacted]'s sole shareholder, and nothing within the four corners of the Forms 1120-S suggested that [redacted] was not the corporation's sole shareholder. If the "four corners of the return" approach of Harrell and Z-Tron were applied in determining whether [redacted] was a small S corporation, [redacted] would have to be treated as a small S corporation. However, we do not believe that the "four corners of the return" approach should be applied to the natural person requirement of Temp. Reg. 301.6241-1T(c)(2). In Harrell and Z-Tron the "four corners of the return" standard was applied narrowly to the same share requirement; nothing in either opinion suggests that it was intended to apply to the small S corporation test which has no provision analogous to the same share requirement. Determining whether the natural person requirement has been met is fundamentally different in that it does not entail the type of interpretative questions which troubled the Tax Court with respect to the same share requirement.

It is important to note that the small S corporation exception was not among the many S corporation procedures which were incorporated into subchapter D directly from the TEFRA partnership provisions of subchapter C by section 6244. Section 6244 extended those provision of subchapter C which related to partnership items to subchapter D. However, the small partnership exception of section 6231(a)(1)(B), which does not directly relate to partnership items, was not among the provisions of subchapter C incorporated into subchapter D. Eastern States Casualty Agency, Inc. v. Commissioner, 96 T.C. 773 (1991). See also, Beard v. Commissioner, 992 F.2d 1516 (11th Cir. 1993). The small partnership exception which the Tax Court interpreted in Harrell and Z-Tron was created by section 6231(a)(1)(B)(i)(II). By contrast, the natural person requirement at issue here was created by, and is wholly defined by, Temp. Reg. 301.6241-1T(c)(2). Nothing in that regulation limits the facts to be considering in applying the small S corporation exception to those revealed within the four corners of the return and attached K-1s. Accordingly, we do not believe that a "four corners of the return" standard should be applied to

the small S corporation exception.[2] Given that [redacted]'s sole shareholder was a trust, and given that the controlling regulation unambiguous excludes corporations with trusts as shareholders from the definition of small S corporations, it is our opinion that [redacted] is subject to the unified S corporation procedures of subchapter D for its taxable years [redacted], [redacted], and [redacted].

Lastly, we note that even if the determination of whether the natural person requirement is met is to be made based on a "four corners of the return" analysis, [redacted] would not qualify as small S corporation for its taxable year [redacted]. The determination of whether an S corporation is a small S corporation is to be made on a year-by-year basis. Temp. Reg. 301.6241-1T(c)(2)(iv). As [redacted] did not file a return for [redacted], the determination of whether it qualifies as a small S corporation must necessarily be made based on the facts as they actually existed during the taxable year.

If you have any questions respecting this matter, please call Jack Forsberg at (651) 452-9269.

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cc: Karen Hubertus, LMSB Group 1625, Bloomington POD;
Associate Chief Counsel (Procedure and Administration); and
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[2] We note that in a situation where an S corporation has made representations as to the identity of its shareholders, and the Service has relied on those representations to its detriment in making the determination that the corporation is or is not a small S corporation, the taxpayer may, depending on the facts of the case, be equitable estopped from contesting the Service's determination.